What Doesn’t Kill Us Makes Us Stronger: But Can the Same Be Said of the Eurozone?

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This comment provides a brief, analytical survey of the European sovereign debt crisis. It aims to be user-friendly and accessible to any reader who wants to learn more about the causes and consequences of Europe’s ongoing troubles. Rather than focus on a particular country, the comment reviews the fiscal Eurozone and its banking system as a whole. It begins by explaining the key, long-term roots of the Eurozone’s present problems. Then, it provides a critical commentary on attempted reforms, and an analysis of the events that have unfolded this past year. It concludes by evaluating the Eurozone’s options for fiscal and structural reform going forward.

I. Introduction

The Eurozone sovereign debt crisis is a moving target. Among other things, its roots are traceable to the 2008 financial crisis, flawed political constructs, risky and dishonest business practices, and faulty economic models. To the lay observer trying to make sense of the crisis, the avalanche of news on politicians, banks, and private market players can overwhelm and obscure. But it is important to wrestle with and understand these issues. The collective Eurozone is one of the world’s largest economies. The debt crisis is rapidly evolving, and whatever happens in the next few years, for good or for ill, will affect everyone.

This paper tackles the issue from a particular angle. It discusses the more significant legal changes occurring within the banking sector in response to the crisis, as well as external legal changes that will impact the banking sector. The ultimate goal of this analysis is to synthesize the underlying causes and consequences of the sovereign debt crisis, and present them in a user-friendly manner. The sovereign debt crisis cannot be understood without bringing in elements of politics, economics, and private debt. But for expediency, this comment focuses on developments at the national level (public debts) and within the European banking sector, particularly the European Central Bank (ECB).

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To frame the discussion, the comment begins with (1) background information on the crisis; (2) a discussion of internal reforms to the banking sector, and a corresponding discussion of the external legal reforms presently developing in the Eurozone; and (3) proposals on where the Eurozone may be headed, and where it should be headed. The banking sector is complicated—this comment aims to be simple.

II. Background: How Did We Get Here?

To analyze the effectiveness of the new European banking regulations and other political reforms, one must first understand the underlying problems they are meant to address. The roots and nature of the sovereign debt crisis are labyrinthine, and so the following background information is by no means exhaustive. Instead, it highlights some of the key factors whose interplay led to the crisis. These factors give context to current reforms and regulations.

A. CRACKS IN THE FOUNDATION

The very adoption of the euro as common currency created two significant problems. First, it fueled sovereign debt by making cheap credit readily available because the Eurozone as a whole enjoyed low interest rates. Nations that would have been weaker individually were buoyed by their association with stronger Eurozone members. Second, it meant that the disparate economic competitiveness of European nations would no longer be automatically adjusted by exchange rate devaluations.1 The second problem is not overly publicized outside the business or market sectors, but it should be. It is systemic, and has become increasingly acute in the past decade.2 For example, between 1998 and 2008, German competitiveness rose by 18 percent, while Ireland, Spain, Portugal, Italy, the Netherlands, and Greece all experienced sharp declines, some by as much as fifteen to twenty percent.3 The result is a competitiveness imbalance of around 30 to 40 percent.4 This spread is accompanied by perversely diverging wages of peers across the Eurozone that persist despite the common currency.5 For example, at the high end of the scale (roughly a 40 percent spread), a job that pays €40,000 a year in Germany would cost roughly €56,000 for its counterpart in Greece.6 But the Greek economy has less capacity and productivity than the German economy, and so there is no logical justification for this disparity. This disparity reveals how Greece used its access to the euro (and Eurozone credit rates) to subsidize a high-spending lifestyle beyond its individual capacity.

2. See Economics & FI/FX Research: Friday Notes, UNICREDIT (UniCredit Research, Munich, Germany), March 26, 2010, at 6 [hereinafter UNICREDIT].
3. See id. at 2.
4. Id.
5. It should be noted that price competitiveness, although a key indicator of overall competitiveness, is not the only one. A country’s specializations or innovations, for example, also impact competitiveness.
6. See UNICREDIT, supra note 2, at 6 (comparing the cumulative growth of compensation per employee in the Eurozone between 2000-2008).
On top of these problems, a distinct lack of oversight plagued the creation of the fiscal Eurozone. Originally, a country that wished to enter the Eurozone was required by treaty to assure its financial stability by meeting the so-called Maastricht Criteria. Generally, this entailed keeping inflation below 1.5% a year and maintaining a budget deficit of less than 3 percent of GDP, as well as a debt to GDP ratio of less than 60 percent. The entry treaties empower the European Commission and Council to monitor member states, and impose sanctions for unrepentant violators. In practice, however, enforcement of the debt criteria was weak, and government and market actors alike ignored and abandoned them. Periphery states like Spain, Italy, and Greece entered the Eurozone by either deferring the politically unpalatable reforms or by cooking the books. Thus, while these less-solvent states enjoyed some of the immediate benefits of entry (i.e., an influx of capital and credit), they remained at a significantly lower productive capacity than other Eurozone states. The image of a teenager with a brand new credit card springs to mind. Italy is an example of a country for which low productive capacity is a bigger problem than price divergence. Today, the Maastricht Criteria is largely a moot point because most Eurozone countries are running huge deficits and unprecedented debts. The Criteria loses both credibility and relevance as countries become either unwilling or unable to comply.

In sum, then, despite a common currency, underlying structural problems of price competitiveness and productive capacity persist within the Eurozone and have intensified under market strain. Also, note the interplay of these problems: a country with less productive capacity but equal access to credit will have a much more difficult time deleveraging in an economic slump. That is, countries with initially lower productive capacities that assume disproportionately massive debts cannot easily or naturally outgrow the burden by boosting GDP.

B. UNSUSTAINABLE DEBT

Unprecedented and unsustainable debts are another root cause of the crisis. The Boston Consulting Group summarizes the scope of the problem of global debt levels as follows:

Total debt-to-GDP levels in the eighteen core countries of the Organization for Economic Co-operation and Development (OECD) rose from 160 percent in 1980 to 321 percent in 2010. Disaggregated and adjusted for inflation, these numbers mean that the debt of nonfinancial corporations increased by 300 percent, the debt of governments increased by 425 percent, and the debt of private households increased by 600 percent.

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8. Id.
11. Id.
12. UniCredit, supra note 2, at 2.
13. Rhodes & Stelter, Collateral Damage, supra note 1, at 2. The phenomenon is, of course, not confined to Europe. Recent figures show the major global economies have a combined government debt of $7.6 trillion.

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From 2000 to 2010, average government gross debt as a percentage of GDP within the Eurozone has risen from 69.2% to 85.3%—well beyond the Maastricht Criteria's 60% limit. Public debt levels have been on an upward trend since the 1970s and have surged in response to the financial crisis of 2008, as governments faced declining revenues, increasing liabilities, and funding various bailout packages. Most Eurozone countries are struggling simply to stabilize their debt, let alone reduce it.

When it comes to European sovereign debt, however, the problem is actually much worse than the debt-to-GDP levels indicate. The true litmus test of sovereign debt is not simply the official government debt figures—it is also a government's unfunded liabilities (that is, the difference between expected tax revenues and the projected costs of continuing present government programs). When one considers both government debt and unfunded liabilities as a percentage of GDP, the resulting fiscal imbalances in Europe are staggering. The average EU country would need more than four times its GDP sitting in the bank and earning interest simply to continue funding its programs. Consider one of the worst offenders—Greece. Eurostat reports that Greece's 2010 government debt to GDP ratio was 142.8%. This is above the average in Europe, but it pales in comparison to Greece's projected unfunded liabilities, which would cost around 875% of its total GDP to continue. Fiscal imbalances this high point to one conclusion with certainty: the euro credit boom is unraveling, and sovereign debt levels are unsustainable in their present form.

Perhaps the most visible sign of systemic, debt-related stress is the series of bailouts financed by the European Union and the International Monetary Fund (IMF). The EU and IMF have provided €85, €110, and €78 billion to Ireland, Greece, and Portugal respectively since the crisis began. The trend has been to pair international assistance with agreed austerity measures. On May 9, 2010, the EU states created the European Financial Stability Facility (EFSF) as an alternative method of financial assistance. The EFSF maturing this year alone. See Mark Deen & Paul Dobson, French Debt Costs Rise at Bond Sale as AAA Decision Looms, BLOOMBERG (Jan. 3, 2012, 11:14 AM), http://www.bloomberg.com/news/2012-01-04/france-takes-market-pulse-with-bond-offering-as-aaa-rating-decision-looms.html.


16. Id.


18. Id. at 8.


20. Gokhale, supra note 17, at 8


22. Id.

is empowered to provide loans to EU nations in trouble, buy bonds on the market, indirectly refinance banks via loans to governments, and issue its own bonds.\textsuperscript{24}

Despite its AAA rating, the basic problem with the EFSF is that the debt-laden European nations fund it.\textsuperscript{25} Earlier this year, Moody's warned France that by choosing to back the EFSF, it was at greater risk of a downgrade because of the additional liability.\textsuperscript{26} Conversely, now that France and several other EU nations have just been downgraded by ratings agency Standard & Poors (S&P), the EFSF is now, itself, threatened with a downgrade—a move that sharply reduces the capital available for its operations.\textsuperscript{27} So far, S&P is the only ratings agency to act on this threat, when it downgraded the EFSF to AA+ in January.\textsuperscript{28} The agency said the move was "inevitable" after the downgrades to France and Austria.\textsuperscript{29} The EFSF is not, itself, the solution to the debt crisis, because as far as the markets are concerned, the health of the EFSF and EU nations is a two-way street.

C. THE BANKING SECTOR

1. Risky Sovereign Bond Holdings

Sovereign debt and financial instability in the banking sector go hand in hand. The largest European banks, even in the supposedly more solvent North, are flush with both national and foreign government bonds.\textsuperscript{30} Until the crisis hit, banks purchased these bonds en masse as a safety bet, with virtually no one questioning a government's ability to pay.\textsuperscript{31} But now, in light of unprecedented national debts and an economic downturn, the threat of a downgrade is pervasive.\textsuperscript{32} A sovereign's downgrade not only reduces portfolio value of government bond-holders who are holding riskier assets, it also negatively impacts national banks by extension.\textsuperscript{33} Data from the Bank of International Settlements (BIS) indicates that a bank's fortunes generally rise and fall along with its home country:

\textsuperscript{24} Id.
\textsuperscript{25} Id.
\textsuperscript{29} Id.
\textsuperscript{31} Fabio Panetta, Chairman, Study Group for Committee on the Global Financial Settlement, Bank for International Settlements, The Impact of Sovereign Credit Risk on Bank Funding Conditions, CFGS PAPERS, no. 43, July 2011, at 30 [hereinafter BIS Report].
\textsuperscript{33} BIS Report, supra note 31, at 20-21.
major "domestic banks are rated at or below their sovereign," and 64 percent of domestic banks experienced a downgrade within six months of their sovereign's downgrade.\textsuperscript{34}

Consider the following trends in the sovereign bond market to see how these risks play out. Since 2009, Spain has seen its ratings slashed three times in three years.\textsuperscript{35} As a result, its cost of borrowing has risen to more than double that of Germany.\textsuperscript{36} Even worse, the downgrades to Portugal, Ireland, and Greece have put their bonds at "junk status" (that is, the bonds are no longer considered investment grade quality because their issuers are a credit risk), and the consequences continue to be felt.\textsuperscript{37} In November 2010, LCH Clearnet (the largest clearinghouse in Europe) boosted margin requirement on Irish bonds to 45 percent, forcing investors to put up huge deposits on the risky bonds.\textsuperscript{38} Greece, struggling to come up with the cash to pay €14 billion of debt maturing March 2012, created a plan to give private bond-holders a 50 percent haircut (i.e., a write down of the bond's value), later raising the rate to 70 percent.\textsuperscript{39}

The larger economies of Europe are not immune from this problem. Just days before the EU December 2011 summit, S&P put fifteen Eurozone nations on a negative credit rating watch-list, including AAA nations like Germany.\textsuperscript{40} S&P's cited a number of factors for the move, including: a credit crunch, rising sovereign yields, political intransigence, high public and private debt, and the likelihood of recession and slacking productivity in 2012.\textsuperscript{41} Fears of contagion reaching Europe's core nations crystallized on January 13, when the S&P downgraded credit ratings on the government debt of nine out of the sixteen European nations on the watch-list.\textsuperscript{42} Cyprus, Italy, Portugal, and Spain fared the worst, with a two-notch hit, while France, Austria, Malta, Slovakia, and Slovenia all fell by one notch.\textsuperscript{43}

In light of rampant sovereign credit risk and the threat of downgrades, banks (and, of course, private investors) have taken stock of their exposure to sovereign debt.\textsuperscript{44} Govern-
ment issued bonds comprise about 60 percent of the European bond market.45 Banks have scrambled to rid themselves of sovereign bonds.46 This trend puts more pressure on governments and coincides with burgeoning public deficits and debts (as previously discussed). Perhaps the single greatest threat to the European banks is a government defaulting on its debt. Because of the level of exposure to foreign sovereign debt, and the interdependence this creates within the Eurozone, the default of one nation, or the bust of a major national bank, could have a cascading effect.47 A run on banks and the threat of contagion is the end-game EU leaders fear the most because it cuts to the core of the Eurozone.48 The impetus to prevent contagion, or a spillover effect, helps to explain the recent actions of EU politicians that are the focus of this comment's later sections.

The French national banks make for an interesting case study of bank exposure to the sovereign bond market. Prior to the crisis, French banks invested heavily in Italian debt, with little incentive to diversify their portfolios.49 As a consequence, today France is exposed to €416 billion of Italian sovereign bonds—107 billion of which is held by the public sector.50 At the end of 2010, half the capital of BNP Paribas was €28 billion of Italian bonds.51 Collectively, France's financial institutions are exposed to the weaker economies of Greece, Portugal, Ireland, Italy, and Spain to a tune of over €680 billion (an amount that equals more than a quarter of France's GDP).52

French banks now face the uncomfortable task of slowly deleveraging and diversifying. In the past nine months BNP Paribas slashed €7 billion of bonds, shedding more bonds from its books than any other European bank.53 But this bank alone held €28.7 billion worth of “GIIPS” or “PIIGS” bonds as of the end of September.54 “PIIGS” is the unflattering moniker that refers to the fiscally weaker Eurozone nations of Portugal, Ireland, Italy, Greece, and Spain, who received a €750 billion package from the EU on May 10, 2010 in the initial phases of the Eurozone debt crisis.55

Additionally, French banks must now juggle domestic stressors. On December 16, 2011, Fitch Ratings downgraded France's credit rating citing its "heightened risk of contingent liabilities."56 On January 13, S&P followed suit, lowering France to AA+.57 Thus,

46. Patrick Jenkins, Martin Stabe, & Stanley Pignal, EU Banks Slash Sovereign Holdings, FIN. TIMES (Dec. 9, 2011, 6:51 PM), http://www.ft.com/intl/cms/s/0/a62f64e-228f-11e1-aedc-00144feabdc0.html#axzz1jSTD44Lg.
48. Id.
52. Deen & Dobson, supra note 13; Fonteccecia, supra note 50.
53. Jenkins, supra note 46.
54. Id.
56. Deen & Dobson, supra note 13.
while French banks are taking steps to limit their exposure to the Eurozone periphery, their fate remains largely intertwined with nations like Italy and Spain, and domestic troubles complicate the deleveraging process. Bear in mind France's predicament in the following discussions on recent developments within the Eurozone.

2. Risky Business

The banking sector has set itself up for failure. The past decades have seen a surge in financial innovations and services in the securities market (i.e., credit default swaps and derivatives trading). Ironically, securitization was originally introduced as a way of reducing risk by chopping up interests in an original loan and selling them to a diverse pool of investors. But instead of banks directly selling these interests to investors, they soon realized the incredible profits available by repackaging and reselling these securities to fellow banks and investment funds, using increasingly complex methods of packaging and valuating. These trades internal to the financial industry created swollen profits that far surpassed the actual worth of the underlying assets of the securities. Thus, leading up to the crisis, "activities internal to the banking system [grew] far more rapidly than end services to the real economy."

Other major problems were inadequate capital requirements and increased leveraging (that is, banks took on significantly greater debts or risks than they had equity). Essentially, leverage is the ability to control large amounts of money by putting up relatively little of one's own money as a margin and financing the rest. In a booming economy, leverage can amplify profits by providing more resources to make profitable investments—for example, using a loan to finance a venture. Conversely, when investments go south or the economy flags, leverage amplifies losses. In the 2000s, banks financed increasingly large debts, without a corresponding increase in equity, and took on greater and greater leverage and risk. In the case of securities, the true risks and leverage ratios were imperfectly understood, due to the complex packaging and valuation methods, or masked by using off-the-books mechanisms (such as "structured investment vehicles" which are not reported on a bank's balance sheet).

A century ago, a typical European bank leveraged assets-to-capital at a four-to-one ratio. Leading up to the crisis, the leverage ratios of some European banks were over fifty-to-one. These risks are astronomical. If a bank is leveraged at twenty-five-to-one, just a 4 percent decline in value of the bank's assets would wipe out all of its equity. And the

59. Id. at 16.
60. Id.
61. Id. at 20.
62. Id. at 19-20.
65. Ferguson, supra note 63, at 3.
securities and derivative swaps were very risky assets to be traded at these levels. Additionally, inadequate capital requirements left banks exposed to massive credit and trading losses that they were unable to absorb once these investments bottomed out.\footnote{See Crisis Worse Than 2008 in Europe as Rescue Options Dim, Gordon Brown Says, BLOOMBERG (Sep. 16, 2011, 3:05 AM), \url{http://www.bloomberg.com/news/2011-09-16/european-banks-grossly-under-capitalized-amid-debt-crisis-brown-says.html}.}

3. **Illiquid Assets & Accounting Rules**

Risky sovereign debt and risky business practices are not the only major problems plaguing the banking sector: the current accounting rules in Europe (as well as the United States) almost completely mask which banks are operating on junk portfolios. To understand how, a little background information may be useful. For accounting purposes, banks generally classify assets under one of two books: the trading, or available-for-sale portfolio (AFS), and the held-to-maturity portfolio (HTM).\footnote{History of IAS 39, IAS PLUS, \url{http://www.iasplus.com/standard/ias39.htm} (last visited March 3, 2012).} An AFS asset must be “marked to market,” that is, its listed value must reflect the current price it would fetch on the open market if sold (fair value).\footnote{Id.} But an HTM asset is measured by the amortized cost, or face value, thus insulating it from any market fluctuations.\footnote{Id.} Consider one illustration: a bank invests in and holds a piece of real estate originally purchased for \(€200,000\). There is an economic downturn, and the market value of the property drops to \(€100,000\). If the applicable accounting regulations force banks to classify the real estate as an AFS asset, the bank’s balance sheet must list the asset as worth \(€100,000\). In contrast, if the rules allow the bank to classify the property as an HTM asset, the balance sheet will list the asset as worth \(€200,000\), despite the market fluctuation.

Before the 2008 financial crisis, banks following International Financial Reporting Standards (IFRS) did not have the option to reclassify securities (i.e., trading assets, by moving them out of the AFS portfolio).\footnote{Id.; Marie Leone, “Spineless?” UK Pressure Targets Fair Value Weakening, CFO (Nov. 11, 2008), \url{http://www.cfo.com/article.cfm/12586836}.} International Accounting Standard (IAS) 39 contained this flat prohibition: “an entity shall not reclassify a financial instrument into or out of the fair value through profit or loss category while it is held or issued.”\footnote{IAS 39 AMENDMENTS, supra note 70, at 6.}

Then, in 2008, the Lehman Brothers collapse sent shock waves through the financial sectors. Banks were desperate to avoid reporting severe losses (and therefore sharp reductions of capital). Shortly thereafter, the International Accounting Standards Board (IASB), bypassing typical due process procedures, amended IAS 39 to weaken the fair-value accounting rules and permit the reclassification of assets from AFS to HTM.\footnote{Id.; Marie Leone, “Spineless?” UK Pressure Targets Fair Value Weakening, CFO (Nov. 11, 2008), \url{http://www.cfo.com/article.cfm/12586836}.} Moreover, the changes applied retroactively, allowing banks to reclassify assets from July 2008 onward.\footnote{Id.} The retroactive date enabled banks to snatch up assets that otherwise would have reflected the shock of the 2008 financial crisis. Former chair of the IASB, Sir David Tweedie, candidly admitted that the amendment was a direct result of intense politi-
ical pressure exerted by the European Commission.\textsuperscript{74} The Commission had made it clear they were ready to legislate around the IASB, and "carve out" IAS 39. Tweedie, who considered resigning over the incident, called the move a "blunt threat to blow the [IASB] away."\textsuperscript{75} Overnight, European banks drew a curtain over massive amounts of mal-investment.

Under this new framework, a bank can create the illusion that a bad loan or bad investment is still performing.\textsuperscript{76} Theoretically, it is even possible for a bank to operate on the spread from depositors and borrowers, meanwhile shelving its mal-investments that it cannot rid from the balance sheet without either writing them off or down. In light of these accounting issues, how can one accurately measure the health of the European banks? Although there is no way to be certain of the banks' true condition under the current accounting regulations, there are two alarm bells to keep in mind: (1) the U.S. banking system by analogy, and (2) the European banks' unexpectedly voracious reaction to the ECB's newly offered lines of credit.

U.S. accounting rules allow for transfers between portfolios similar to amended IAS 39.\textsuperscript{77} When the financial crisis of 2008 struck, Congress approved the $700 billion TARP bailout for the banks. The true cost of the bailout, however, was revealed by the GAO's partial audit of the Federal Reserve. It turns out that Wall Street (as well as some foreign banks) received $16 trillion worth of undisclosed, unrecorded loans in 2008.\textsuperscript{78} This gives us an idea of the systemic levels of mal-investment U.S. banks' balance sheets, and suggests that the Federal Reserve feared that acting publicly could create a panic. The other troubling indicator is the number of European banks who leaped at the newly offered ECB lines of credit in December 2011.\textsuperscript{79} Economists predicted that roughly €293 billion of loans would be issued.\textsuperscript{80} Instead, 523 banks borrowed €489 billion in the largest-ever single operation by the ECB.\textsuperscript{81} The second round of loans eclipsed this number. At the end of February 2011, over 800 banks had borrowed €529 billion from the ECB.\textsuperscript{82} The scramble may have reflected the banks' desperation to repair their balance sheets.

Moreover, banks have other ways of beefing up their balance sheets. For example, banks routinely issue their own stocks and bonds to fellow financial institutions and pri-

\begin{thebibliography}{99}
\bibitem{74} Leone, supra note 72.
\bibitem{75} Id.
\bibitem{80} Id.
\bibitem{81} Id.
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vate investors. In distressed markets, if the value of these bonds goes down, the bank can record the difference in value as income. So, if a €10,000 bond declines in value to €8,000, the bank may list a €2,000 income, even though it must eventually repay the investor. Lehman Brothers also infamously used British accounting tricks to temporarily remove $50 billion of assets from its books before its quarterly reports. While such maneuvers temporarily make the balance sheet look healthier, they do very little in terms of true growth. Connecting the dots reveals Europe's dirty little secret: the real problem in the banking sector is not liquidity, its solvency!

4. The Interplay between Bank Instability and Sovereign Instability

Note the dilemma: even if a country like Germany wanted to raise money to bail out a fellow EU member, it would have to borrow from its own banks, who are themselves saddled with well over a €100 billion worth of mal-investment and "PIIGS" bonds that are not even marked to market. If a government defaults on its debt, banks holding sovereign bonds of that government will be forced to write them off as a loss—the illusion of value as an HTM asset lost. Such a move could easily trigger a panic or run on the banks depending on the level of exposure.

Unfortunately, all of these factors feed upon each other and manifest in market volatility as investors grow anxious. Take, for example, one recent trend: the rising yields on government issued bonds. Surging yields can create a vicious cycle. As bankers become increasingly worried about a country's ability to pay its debts long-term, the demanded price for lending rises. As the cost of borrowing rises for a government, it will have more difficulty paying off its short-term debts. When the yields are high enough, the government is forced to operate its budget on credit-card like rates. Then, in turn, when the government's bond rates rise, the value of bank's portfolio containing those bonds will fall. Finally, the banks protect themselves by selectively issuing credit, which can hurt businesses, slow growth, and so on. Volatile yield trends are one indication that a crisis of confidence is developing.

III. ECB Banking Regulations: Internal Reforms

In light of this background information on the scope and character of the Eurozone crisis, one can critically evaluate the banking sector's response. The ECB is a logical starting point for tackling this question. The ECB is capitalized by the European System of Central Banks and the various European National Central Banks, in proportion to their


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respective populations and GDP. In December 2010, the ECB gave its capital levels (now, upwards of €10 trillion) a boost. The ECB is perhaps the only institution that can credibly put up enough capital to purchase government bonds en masse, similar to the Federal Reserve’s quantitative easing strategy (i.e., printing the money and buying up the bonds directly).

In 2009, the ECB began to amend and supplement its existing legal framework in light of the sovereign debt crisis. Some of the changes are temporary stopgap measures. Others are permanent amendments. These reforms, which are already in effect, demonstrate that the ECB is waging a multi-front battle. Notably, the national central banks within the Eurosystem are meant to comply with these policies. The following provides an overview of the recent changes and some analysis of their role in the crisis management.

A. REFORMS TO MONETARY POLICY INSTRUMENTS AND PROCEDURES

One of the clear focal points of reform is banks’ treatment of asset-backed securities. In particular, the new guidelines strengthen risk assessment mechanisms. One of the goals of risk-assessment is to ensure there is adequate collateral behind credit operations. Under the new reforms, a debt instrument eligible to be an asset underlying a credit operation (i.e., “cash flow generating assets backing the asset-backed securities”) “must not consist, in whole or in part, . . . of tranches of other asset-backed securities . . . of credit-linked notes, swaps or other derivatives instruments.” This is a clear response to the tranches of mortgage-backed securities that wreaked havoc in 2008.

Likewise, the ECB retooled the credit assessment framework for asset-backed securities. For those asset-backed securities that are eligible, the ECB now applies a stringent credit assessment. To meet the credit quality threshold (that is, the minimum criteria for high credit standards), the asset should (1) have a “triple A” assessment at issuance and (2) maintain a minimum rating of “single A” over the life of the asset. Securities issued on or after March 1, 2011 must undergo two separate credit assessments, both of which must

88. Id.
91. See id.
92. See Protocol (No. 4), on the Statute of the European System of Central Banks and of the European Central Bank, art. 18.1, 2010 O.J. (C 83) 230, 238.
94. Id. at 35.
meet the credit quality threshold.\textsuperscript{95} Other reforms are discretionary provisions, and provide banks with ways to demand assurances of a counter-party’s financial solvency.\textsuperscript{96}

The ECB also addressed bank bonds as a source of risk. To “safeguard the Eurosystem against credit exposure,” the ECB limited the issuance of uncovered bank bonds as collateral assigned to a counter-party.\textsuperscript{97} The bonds should only make up 10 percent of the total collateral. But government guaranteed uncovered bank bonds are exempt.\textsuperscript{98} Notably, this limitation fails to address the accounting games banks play when they record declining bond values as income.\textsuperscript{99}

To ease some of the pressure on banks, the ECB has also broadened the scope of acceptable collateral that counter-parties may use to obtain credit.\textsuperscript{100} Fixed-term deposits (i.e., a deposit that must remain at the bank until its maturity, which is usually a few months or years) now qualify as non-marketable assets, in addition to credit claims and non-marketable retail mortgage-backed debt instruments (RMDBs).\textsuperscript{101} In 2008, the ECB temporarily expanded eligible collateral to include (1) collateral denominated in U.S. dollars, British pounds sterling, or Japanese yen; (2) syndicated loans; (3) debt instruments issued by credit institutions and traded on non-regulated markets; (4) collateral (excluding asset-backed securities) with a “BBB-” credit assessment; and (5) subordinated assets, so long as a financially sound guarantor provides an irrevocable guarantee.\textsuperscript{102} These emergency measures were originally set to expire in December 2009, but the ECB elected to extend them until December 2010.\textsuperscript{103} If the economy worsens, the ECB could easily run similar programs in the future.

Another set of reforms touches on the application of minimum reserves. A 2003 regulation details the requirements of minimum reserves for credit institutions and empowers the ECB to make exemptions.\textsuperscript{104} A 2008 amendment specifies the types of institutions the ECB may exempt under this power, including: institutions undergoing reorganization, institutions whose funds have been frozen by the state, and miscellaneous institutions that the ECB deems would not benefit from the minimum reserves requirement.\textsuperscript{105} This last

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\caption{Figure 1: Graph of Monthly GDP Growth Rate by Country}
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\begin{tabular}{|c|c|c|}
\hline
Country & GDP Growth Rate & 2005-2010 Average \%
\hline
USA & 2.5 & 2.3
\hline
Japan & 0.5 & 0.7
\hline
Germany & 2.0 & 1.9
\hline
\end{tabular}
\caption{Table 1: GDP Growth Rates by Country for 2005-2010}
\end{table}

\textsuperscript{95} See, e.g., id. at 30 (stating “[t]o decide whether its rights are adequately protected against claw back rules, the Eurosystem may require other documents, including a solvency certificate from the transferee, for the suspect period”).
\textsuperscript{97} Id. at 60.
\textsuperscript{98} Id.
\textsuperscript{99} Id.
\textsuperscript{101} Id. at 65.
category in particular should give the ECB broad flexibility in terms of how it chooses to
treat banks in financial straits.

B. EXTERNAL MEASURES: THE CBPP & SMP

On May 7, 2009, the ECB announced it would launch the Covered Bond Purchase
Program (CBPP), whereby it would take the extraordinary step of direct market interven-
tion.106 Under the program, the ECB conducted outright purchases of covered bonds up
to €60 billion over the course of a year.107 Covered bonds are the brainchild of the
Eurozone, which invented them. The covered bond is a debt security backed by a pool of
various loans (typically mortgages or public sector loans). Of the 422 bonds purchased, 27
percent were from the primary market and 73 percent from the secondary market.108

The stated goals of CBPP were to (1) assist the decline in money market term rates, (2)
ease funding conditions for financial institutions, (3) encourage credit institutions to
maintain or expand lending, and (4) improve liquidity in the private debt securities mar-
ter.109 Essentially, this amounts to a kind of miniature, or indirect, quantitative easing,
whereby the ECB scoops up mortgage-backed securities and public sector loans in order
to shore up bank funding.110 The ECB launched a second round of bond purchases
(CBPP2) in November 2011, this time for €40 billion worth of bonds.111

The CBPP goes hand in hand with the Securities Market Program (SMP) launched in
2010.112 The SMP allows the ECB to buy up sovereign bonds on the secondary markets
(i.e., from other investors, and not directly from the governments).113 As of December
2011, the ECB made purchases worth €207 billion under the program.114 Although the
ECB has not released any data on the composition of these purchases, the general consen-
sus is that the ECB has made targeted purchases of GIIPS bonds from the most distressed
regions of the Eurozone.115

These programs are not without controversy. A few noteworthy German bank officials
actually resigned in protest over the programs.116 Critics of the bond-buying program
fear that the ECB will go a step further and engage in direct quantitative easing (i.e.,

106. John Beirne et al., The Impact of the Eurosystem’s Covered Bond Purchase Programme on the Primary and
scpops/ecbocp122.pdf.
107. Id.
108. Id.
109. Id.
110. Esteban Duarte, ECB Said to Start 40 Billion-Euro Covered Bond Purchases, BLOOMBERG (Nov. 10, 2011,
under-new-program.html.
111. Id.
112. Decision ECB/2010/5, of the European Central Bank of 14 May 2010 Establishing a Securities Market
Programme, 2010 O.J. (L 124) 8, 8-9.
113. Id.
115. Driven by the Markets? ECB Sovereign Bond Purchases and the Securities Markets Programme, at 5 (June 8,
20100610ATT75796EN.pdf (by Ansgar Belke).
article/2012/01/17/us-ecb-nowotny-idUSTRE80G23R20120117.
printing money). They believe these market interventions on the ECB's part undermine the bank's political independence and focus on price stability. Others consider these interventions as tantamount to quantitative easing. To counter these accusations, the ECB is currently attempting to "sterilize" the purchased bonds (i.e., counter-balance the purchases by having banks deposit the same amount the ECB has spent).

Another source of contention is the way the SMP redistributes risk. The ECB assumes the liabilities from the bonds when it makes these purchases. In the event of a sovereign default, the ECB ultimately would have to pay the losses on these bonds—thus shifting the risk to the other NCB's who actually capitalize the ECB. Small wonder the German bankers protested. Currently, the ECB is weighing its options and looking for alternatives to the bond-buying program.

C. THE REFORMS IN PERSPECTIVE

The obvious criticism of the reforms to monetary policies and instruments is that they are largely reactionary and likely too little too late. Stricter credit-assessment safeguards may help avert a future crisis, but they do not address the massive amounts of mal-investment already on the books. As long as banks and governments are unwilling to liquidate this debt, the balance sheets of European banks will remain in disrepair. Banks will continue to use creative accounting measures to mask the under-performing or illiquid assets.

Ultimately, the CRPP and SMP amount to creative methods of putting out fires. Thanks to ECB's ability to purchase sovereign bonds, banks have been able to deleverage sovereign debt, shedding risky bonds from their books more quickly than they would otherwise be able to on the open market. But the downside to this strategy is that banks are becoming increasingly dependent on the ECB to meet their short-term funding needs. Bolstering funding is more like a shot of adrenaline than a cure—it keeps the banks functioning at the status quo for the short term, but it does not treat the underlying problems of insolvency and debt.

In fact, the banks' own debt will present yet another huge obstacle in 2012. Consider the growing deficit between newly issued bank bonds, and maturing ones: (1) in 2010 the difference was €33 billion; (b) in 2011, that number leapt to a €110 billion that the ECB helped to finance; and (c) in 2012, there is €802 billion worth of maturing debt. The ninety largest banks in Europe will need to roll nearly €5 trillion of debt in the next

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117. Id.
118. Id.
119. Belke, supra note 115, at 6-7 (noting that the key aspect of QE has been targeted interventions in bond markets to get market interest rates down—precisely what the ECB is now doing via the SMP).
120. E.C.B. Slowed Purchases of Government Bonds, supra note 114.
121. Belke, supra note 115, at 5.
122. Id. at 6.
123. ECB Mulling Alternatives, supra note 116.
124. See Jenkins, supra note 46.
127. Id.
twenty-four months. The amount equals 51 percent of the Eurozone’s GDP. The ECB’s purchase programs may help cushion the blow of immediately maturing debt, but the funding from these programs is a drop in the bucket compared to the banks’ true short-term funding needs.

The programs target the most distressed markets, and may be useful in terms of alleviating immediate pressures (i.e., rising yields). But they are not a real solution, per se. They do not address the underlying structural imbalances in Europe of diverging competitiveness, fiscal insolvency, and burgeoning debts. True, the ECB is not necessarily responsible for fixing Europe—structural changes should be implemented at the legislative level.

IV. Latest Developments and Structural Reforms

A. NOVEMBER 2011: EMERGENCY U.S. DOLLAR LOANS

In November 2011, Europe was at a tipping point, and Italy was the culprit. Italian sovereign debt stood at €1.9 trillion—an amount greater than the collective sovereign debt of Ireland, Spain, Portugal, and Greece. Its debt to GDP ratio was correspondingly high at 120% (the largest in Europe after Greece). At these figures, Italy required a primary surplus of 5 percent GDP simply to stabilize its debt load—a difficult goal given the current recession and Italy’s newly imposed austerity measures. Any restructuring of Italian debt, however, would be a body-blow to the French banks, which (as previously discussed) remain heavily exposed to Italian sovereign bonds. On November 9, LCH Clearnet triggered a panic when it posted a margin call against Italian government bonds. Suddenly, banks trading Italian bonds, or using them as collateral “either had to come up with billions of euros in extra cash or would have quickly had to sell some of their holdings.”

The market increasingly echoed this tension as the price of Italian yields surged. As previously discussed, soaring yields can trigger a vicious cycle for both banks and sovereigns. Even with the ECB “aggressively” buying up Italian bonds, investors continued to sell off Italian bonds. The recently announced haircuts to Greek bonds (at that time,}

129. Id.
131. Id.
133. See Benedetti-Valentini, supra note 130.
134. Rushing for the Exits, THE ECONOMIST (Nov. 12, 2011), http://www.economist.com/node/21538195. Margin is the percentage of equity an investor personally puts into a margin account, usually allowing her to invest with additional, borrowed money to amplify profits. See Margin Trading: The Dreaded Margin Call, INVESTOPEDIA, http://www.investopedia.com/university/margin/margin2.asp#axzz1zdB6P00 (last visited July 22, 2012). When the value of the account drops, the broker makes a “margin call,” forcing the investor to either deposit more money into the account or sell some of the account’s assets. Id.
135. Rushing for the Exits, supra note 134.
136. See Snyder, supra note 86.
WHAT DOESN'T KILL US

potentially 50 percent to private bondholders) did nothing to soothe the markets. The ripple effects were visible as Spanish, Belgian, Austrian, and French bonds also spiked. In November, Italian yields peaked at around 7.5%. These are the critical levels that forced Portugal and Greece to ask the EU-IMF for a bailout. In Italy's case, however, the cost of a bailout would be astronomically higher—the EU-IMF simply could not foot the bill this time around. In the words of one credit strategist, "Italy is too big to fail and too big to bail... We don't have enough of a cushion in the European banking system to take a meaningful haircut on Italian debt." The response came on November 30 when six central banks, including the Federal Reserve and ECB, took "coordinated action." The banks announced that starting December 5, (1) the current pricing of the U.S. dollar would drop fifty basis points, and (2) the Fed would open up a new round of dollar swap lines. Originally, the existing swap lines had been set to expire in August 2012, but, under this plan, they were extended until February 1, 2013. This means that for an extended period of time the other central banks can exchange their own currencies for cheap loans of U.S. dollars. Then, these central banks in turn may lend them to the various financial institutions of their countries at auction.

Officially, the stated purpose of this coordinated move was to “ease strains in financial markets and thereby mitigate the effects of such strains on the supply of credit to households and businesses and so help foster economic activity.” There is good reason to be skeptical. After the historic stimulus of 2008, when U.S. banks were flooded with cheap capital, the money did not automatically flow back into the private sector. Why should this time be any different? Rather, an analysis of these coordinated moves should follow the money down the pipeline. The swap lines tell a different story than the explanation offered by the Federal Reserve. Consider the ensuing developments in December 2011.

137. Id.
138. Id.
139. Rushing for the Exit, supra note 134.
141. Schwartz & Alderman, supra note 49.
144. Lanman & Black, supra note 142.
145. Watts & Robb, supra note 143.
146. Id.
147. Id.
B. December: LTRO and The EU Summit

Shortly after the Fed opened the spigot on dollar swaps, the newly liquid ECB announced it would launch its “long-term refinancing operation” (LTRO).\(^\text{149}\) Beginning December 21, the ECB offered European banks a sweetheart deal: loans at 1 percent financing with a three-year maturity.\(^\text{150}\) The logic behind this is simple. The Fed loans U.S. dollars to the ECB at fifty basis points. The ECB then loans these same dollars to the various European banks at 1 percent. The hope, then, is that these European banks will use these loans to purchase sovereign bonds—especially the highly yielding ones. If, for example, a bank used this money to purchase a sovereign bond yielding at 7 percent, it could report a 6 percent profit. This is what is referred to as a “carry trade.”

As mentioned earlier, an unexpectedly voracious reaction by the banks followed. Over 500 banks borrowed over €400 billion under LTRO in December 2011, and over 800 banks borrowed over €500 billion in February 2012.\(^\text{151}\) In the short term, the strategy seems to have worked. Italian and Spanish bonds have receded from critical levels.\(^\text{152}\) Banks have more profits to report. Consequently, it appears that the purpose of the dollar swaps is not to assist “households and businesses” as claimed. Instead, it seems likely these operations were specifically targeted to avert an imminent credit crunch, allowing Italy and other periphery nations continued access to affordable credit, and to help the banks repair their tattered balance sheets.

Although these coordinated maneuvers in the banking sector may have averted an immediate funding crisis for Italy and Spain, significant problems are on the horizon. First, these carry trades only kick the can down the road. Even with an injection of billions of euros, European banks still have to roll trillions of euros of debt in the next two years.\(^\text{153}\) The strategy of borrowing from the ECB to grease the wheels for sovereign bond purchases is not a sustainable one. First and foremost, the massive debt loads of both banks and sovereigns must decelerate to sustainable levels. Otherwise, investor confidence in the sovereign bond market will continue to erode. Even triple ‘A’ Germany has felt the effects with a failed bond auction.\(^\text{154}\) Second, these carry trades may cause more damage in the long term. The trades strengthen the connections between and the interdependence of sovereigns and banks, making each more exposed to “future shocks.”\(^\text{155}\) Third, there is no guarantee the banks will actually use these loans to reinvest in the sovereign bond market. As discussed, banks have largely tried to deleverage in the past year. It may be more attractive to them to invest in safer, even if less profitable, yielding


\(^{150}\) Id.

\(^{151}\) See Thesing & Buergin, \textit{supra} note 79; Flanders, \textit{supra} note 82.

\(^{152}\) Worrachate, \textit{supra} note 140.

\(^{153}\) Boone & Johnson, \textit{supra} note 128.


\(^{155}\) Jenkins, \textit{supra} note 46.
bonds like those of Germany. Or they may be entirely focused on using the funds to refinance and roll over their massive debt loads.\textsuperscript{156}

The ECB timed its announcement of LTRO to coincide with the EU December 9 summit. This summit marked a major shift in Europe’s political and legal trajectory. Germany and France pushed for fundamental changes to the EU treaty, whereby the European Commission could police national finances. The plan called for prior EU approval of national budget plans, as well as automatic sanctions for countries that overspend.\textsuperscript{157} David Cameron, unable to secure a U.K. waiver for the more stringent financial measures, took the extraordinary step of vetoing the treaty changes.\textsuperscript{158} Undaunted, Germany and France proposed that the changes be implemented via inter-governmental treaty instead.\textsuperscript{159} The plan required a significant abdication of national sovereignty—ultimate control over national finance. Perhaps emboldened by the United Kingdom, the Czech Republic, Sweden, and Hungary have also expressed their hesitation.\textsuperscript{160}

Recently, Angela Merkel provided insight on what the new EU might look like under the treaty:

"Over a long process, we will transfer more powers to the [European] Commission, which will then handle what falls within the European remit like a government of Europe. That will require a strong parliament. A kind of second chamber, if you like, will be the council comprising the heads of [national] government . . . And finally, the supreme court will be the European court of justice."\textsuperscript{161}

Such close-knit integration of politics and finance sounds more like a United States of Europe than the present EU. The treaty focuses on one of the main sources of the crisis—reining in reckless national spending by holding each state accountable. But the agreement failed to address key issues. It says nothing of the future for rescue operations like the EFSF, how to support flagging nations, or Greece’s much-needed restructuring. Nor does it address the other sources of the crisis, namely, the rising competitiveness imbalance among EU nations. The S&P cited these shortcomings of the summit when it downgraded several EU nations in January 2012.\textsuperscript{162} It also warned that reforms based on “fiscal austerity alone” can be “self-defeating” in an economic downturn.\textsuperscript{163}

C. SPRING SHAKEUPS

The shifts in Europe’s political landscape this past spring could define the next phases of the crisis. German Chancellor Angela Merkel and the proponents of an austerity-dom-
inated reform program lost a powerful ally this May, as French President Nicolas Sarkozy was ousted from office.\textsuperscript{164} His successor, François Hollande, presents a very different vision for Europe. Hollande, a Socialist, has pronounced that “[a]usterity need not be Europe’s fate,” and hopes to stir growth through mechanisms like tax-hikes and government stimulus.\textsuperscript{165} Germany still has like-minded allies in smaller nations like Holland and Finland, but it appears the Franco-German dominated Eurozone (evident at the December 2011 summit) has splintered.\textsuperscript{166} Political fractions and incoherent leadership could prove fatal to both visions for Europe. These developments also present a major hurdle for Merkel’s vision of closer political integration within the Eurozone.

There was also political pushback in Greece this spring. Austerity-fatigued and entering their fifth year of deep recession, the Greeks punished the traditionally dominant parties at the polls. No party or coalition won enough seats to form a parliament during “an inconclusive May 6 vote,” and the voices on the radical left are growing.\textsuperscript{167} The Syriza coalition is calling for continued Eurozone funding without the austerity program, under the threat that Greece will simply walk away from its debts if its funding dries up—a scenario that plays directly into the fears of the bailout-fatigued proponents of austerity.\textsuperscript{168}

In light of this political flux, a quiet run on distressed banks is taking shape. Spanish depositors withdrew more than a billion euros from Bankia in a week after Spain announced that it would nationalize the troubled bank.\textsuperscript{169} Spanish bond yields have surged dangerously in response.\textsuperscript{170} Meanwhile, the ECB has used one of the weapons in its arsenal, the “emergency liquidity assistance” (ELA), to keep Greek banks on life-support.\textsuperscript{171} Barclays estimates that Greece is currently using upwards of €90 billion worth of ELA.\textsuperscript{172} As politicians vacillate and elections loom, the ECB wields unprecedented political power, even if they do not exercise it. If the ECB chose to withdraw its support, it could force Greece into a disorderly exit.\textsuperscript{173} Consider what this says of the growing dependence on the ECB for short-term funding.

\textsuperscript{165} Id.
\textsuperscript{168} Id.
\textsuperscript{170} Id.
\textsuperscript{171} Ralph Atkins, \textit{Secret EUR100bn Assistance Propming Up Greek Banks; Central Funding}, \textit{FIN. TIMES}, May 22, 2012, at 5.
\textsuperscript{172} Id.
\textsuperscript{173} See id.
V. What Does the Future Hold?

A. The Immediate Problem: Greece Should Exit the Eurozone Despite the Risk of Contagion

Greece is in a precarious situation. It had been edging towards a disorderly default on March 20, 2012, when a €14.5 billion bond payment became due. To avoid this, the Greek government had to wage a two-front battle with private bondholders and the EU. In the early months of 2012, Greece sought to renegotiate the value of its bonds and to strike a deal with the EU-IMF for another bailout—this time for €130 billion. The bondholders, once debating 50 percent devaluation, now have little choice but to accept a devastating 70 percent haircut on their notes. Understandably, this has prompted calls for the ECB (one of Greece’s largest public bondholders) to likewise share the burden of a haircut. After all, why should private bondholders be treated as second-class creditors?

But EU leaders held up the show. They refused to let Greece sign off on the €200 billion bond restructuring program unless it also accepted another round of austerity measures to bridge its financing gap. The EU plan requires deep cuts, including a 25 percent drop in private sector wages and 35 percent in pensions, as well as cutting thousands of government jobs. Essentially, the EU was playing hardball by threatening Greece with a disorderly default should they fail to step in line behind its austerity plan. Amid much controversy and violent protests, Greek lawmakers passed the austerity package—kicking the can down the road once more. The EU refuses to release any bailout funds until the austerity measures are credibly implemented. Given the inconclusive May 2012 elections, it is highly speculative whether Greece can muster the political will to follow through on these measures.

Europe’s leaders have begun to question whether Greece is worth saving. In reality, propping up Greece may no longer be an option. It may be beyond saving. The bailout-austerity program in place is not sustainable. Greece’s previously imposed austerity measures have only exacerbated its recession. The EU’s latest plan for Greece will turn the screws on its already beleaguered economy. As one Greek politician objected, the EU is “asking for more recession than the country can take.” Meanwhile, past bailout funds have benefited Greece’s private creditors, but not Greece itself. The money pumped into Greece by the EU and IMF flowed right back out again to Greece’s creditors, mainly the banks. If it continues on its current path of bailout-austerity, Greece is headed for a prolonged depression marked by deflation. It will continue to drain Eurozone resources

175. Hope, supra note 39.
176. Id.
177. Id.
180. Hope, supra note 39.
182. Id.
as economic growth lags and expensive, euro-denominated debt piles up. If Greece stays with the Eurozone (or rather, if the Eurozone stays with Greece), it will not be long before it must come to the EU-IMF for funding once again. But Greece’s debt-load remains unsustainable. If a bailout-austerity program is not the answer, then what is? The alternatives to an EU-dominated program are either default or deep restructuring. An orderly exit from the Eurozone is the least damaging way to restructure and avoid an outright default on public debt. Greece should be allowed to de facto default by redenominating its debts under the Greek drachma.

True, the immediate domestic fallout will be severe in Greece. Without market access, Greece would have to monetize its debt. A period of sharp inflation and economic depression would surely follow. But Greece should look to Iceland as a model. Iceland defaulted on its debts, bucked the euro, and redenominated with its old currency. A sharp and painful correction followed, but within three years it was able to re-enter the bond markets. Greece too can restore genuine growth by first renegotiating its debts under the new currency and suffering through a period of sharp depreciation. An exit will also free up precious Eurozone resources. Instead, these resources can be used to strengthen the Eurozone’s core and to assist Greece’s transition.

But what of the grave threats sovereign defaults pose to the banking sector? Greece is not Italy—its economy is small enough to allow an exit. But the external contagion of a de facto default would still be acute. It can and should be contained. Nouriel Roubini proposes a practical exit strategy for Greece. He argues the Eurozone should not abruptly cut-off Greece. Instead, the ECB and Greece should coordinate how to convert Greece’s debts into drachmas. By negotiating the exchange rate, Greece can (and should) avoid an outright default. In exchange for Greece’s agreement to a long-term plan for achieving a primary balance, the ECB could redirect funds to recapitalize Greek banks. This would help minimize the fallout. But the window to implement such a strategy is rapidly closing.

B. WHAT WILL THE NEW EUROZONE LOOK LIKE?

Even if the Eurozone cuts Greece loose, it must still get its fiscal house in order. Europe is awash with debt and liabilities. Most commentators agree that a disorderly breakup of the Eurozone would be disastrous. But if breakup is to be avoided, European nations must implement reforms that go beyond curbing volatility and that address

185. Id. at 3.
186. Id. at 9.
187. Id.
188. Id.
189. Id.
190. Id.
191. Id.
the root causes of the crisis. This means addressing not simply sovereign debt and bank insolvency, but also Europe’s massive trade and competitiveness imbalances.\textsuperscript{193}

1. \textit{An Orderly Breakup?}

Controlled exits are better (or less bad) options than chaotic ones. Conceivably, countries could exit the Eurozone and return to competing currencies. This scenario would allow for market-driven solutions. Natural currency devaluations and exchange rates would account for competitiveness and trade imbalances amongst nations, for example. Ideally, the change-overs would occur gradually and with strict government oversight.\textsuperscript{194}

There are major downsides to this strategy. For starters, you cannot unscramble the omelet of the banking sector. The banks’ balance sheets have no geopolitical borders. The market links them all through mechanisms, such as the derivatives trades.\textsuperscript{195} And as bondholders, European banks still have a major stake in each nation’s economic well-being. Also, redenominating debts would be costly and difficult to say the least. The validity and value of contracts, whose terms contemplate use of the euro, would be questioned. European governments would have to implement well-planned, and well-executed transitions to prevent bank runs (i.e., declare an unexpected bank holiday and implement the changes overnight, and simultaneously implement controls on trade, capital, and borders).\textsuperscript{196} Market players may also exacerbate volatility by jumping between currencies during the transition periods (never let a good crisis go to waste).\textsuperscript{197}

This scenario is unlikely at present. In fact, the chances are practically nonexistent. There appears little, if any, political will to return to competing currencies. It simply has not come up for discussion amongst the EU leadership. True, nations like Germany may privately have a backup plan for their own quick exit should things turn ugly. But we are more likely to see a chaotic, accidental breakup of the Eurozone than a coordinated one. On the other hand, if the common currency is to survive, the Eurozone will have to address its internal structural imbalances.

2. \textit{A Fiscal Union Within a Union?}

The route seemingly favored at present is to impose a “stricter supranational disciplinary element in Europe.”\textsuperscript{198} That is, reform will come from the top down. The new inter-governmental treaty, for example, would favor centralized financial controls. Mohamed El-Erian, the CEO of PIMCO, predicts the creation of a “smaller and less imperfect Eurozone that has a different relationship with the rest of the EU.”\textsuperscript{199} In other words, Eurozone countries that either cannot or will not control their deficits and debts

\begin{itemize}
\item \textsuperscript{196} Rhodes & Stelter, \textit{Collateral Damage}, supra note 1, at 12.
\item \textsuperscript{197} Smaghi, \textit{supra} note 194.
\item \textsuperscript{198} Id.
\end{itemize}
would get kicked out, and the remaining Eurozone would battens down its hatches. El-
erian is on the right track. Already this scenario is playing out in the struggle between
Greece and the EU-IMF. The EU essentially told Greece it either must accept EU over-
sight or go bankrupt. Then, even after Greece’s parliament passed the controversial
austerity measures, Germany’s finance minister suggested that Greece should suspend its
upcoming elections and install a technocrat instead. One has to wonder whether the
Eurozone has truly lost all respect for national sovereignty, or if Greece is deliberately
being shown the door.

But closer integration within the Eurozone has some troubling aspects. First, there is
the danger of massive collateral damage if a country like Greece or Portugal is forced out
in a disorderly way (i.e., if it is pushed into an unplanned default). Also, for the remaining
Eurozone nations, political independence could be compromised. EU leaders like Merkel
(and formerly, Sarkozy) are pushing for unprecedented EU control over traditionally in-
ternal national affairs. An executive board member of the ECB has suggested that per-
haps the “cathartic effects of crises” will bring about this shift of authority towards the
“supranational” level. The idea of waiting until Europeans’ backs are against the wall to
usurp powers traditionally reserved to sovereign governments is a radical one. Europeans
should beware of the ECB or the European Commission dictating their futures if closer
political integration is not truly what they want.

Despite these controversies, this is the path Europe is most likely to take given the
growing divisions between the fiscal Eurozone and the larger, political EU. The EU De-
December 2011 summit and the recent developments in Greece point towards a growing
divide. Also, there has already been political pushback against the ECB’s attempts to cen-
tralize fiscal policy. In the first ever legal proceeding of its kind, the British government
filed a lawsuit against the ECB after it enacted a new restriction on clearing houses.
The regulation would require all clearing houses that clear Euro-denominated securities
to be physically located within the Eurozone. London, where 40 percent of over-the-
counter derivatives global trade is based, would be cut off from this market. The finan-
cial heavy-hitter LCH Clearnet would likely be forced to shut its doors. The lawsuit
points towards a fracturing of Europe’s current dual-union structure and a movement
towards a more tightly integrated political and fiscal Eurozone—a new union within the
union. It remains to be seen which nations are either willing or able to be a part of this
new union.

3. Focus on Fiscal Reforms?

The “union within a union” scenario seems the most likely structural reform. But it
may occur in conjunction with direct fiscal reforms. If Eurozone leaders want to control

200. See Papadimas & Papchristou, supra note 174.
201. Kerin Hope & Peter Spiegel, Tensions Over Bail-Out Rise Between Greece and Eurozone Countries, FIN.
203. Smaghi, supra note 194.
205. Id.
206. Id.
the type of fiscal reform (i.e., instead of the market choosing for them), they will have to act swiftly. The longer they vacillate, the more options will be foreclosed under market strain. To have any effect, fiscal reforms would have to address Europe’s crushing debt. This means the reforms would either have to reduce or restructure the existing debt.

For starters, the less likely option is debt reduction. There are three avenues to debt reduction: (1) growth, (2) inflation, and (3) under-consumption and savings. Ideally, a country would naturally grow its GDP to counteract its debt. But this is unlikely given the current recession. Investment and demand are both slow-moving, and significant growth would be necessary just to stabilize the debts of some countries. Inflation is another route to overall debt reduction and perhaps the default solution (that is, if the markets react more swiftly than the politicians). But generally, governments have kept interest rates artificially low in spite of massive capital injections. The danger that governments fear, of course, is inflation spiraling out of control as the public loses faith in the currency.

The alternative is under-consumption and savings. Given the inability of countries to grow, and the unwillingness of governments to inflate, this is the most likely choice for debt reduction. In fact, we have already seen Greece and Portugal accept tough austerity measures. Theoretically, countries could rebuild savings and pay down their debts by living below their means. But this route is dangerous if the private and public sectors both pursue it simultaneously (i.e., via under-consumption and austerity measures). Recessionary symptoms already present will become amplified. Slow growth and unemployment, for example, could spike. To counter a deep recession, a country would have to run a trade surplus. But to achieve a trade surplus without growth, a country would have to significantly lower its labor costs. This would hurt the little guy.

If debt reduction proves impractical, the second option for fiscal reform is debt restructuring. It is more likely that banks and sovereigns will choose this path. There are three extreme forms of debt restructuring that Europe may pursue: (1) outright quantitative easing, (2) issuance of Eurobonds, and (3) controlled write downs.

Quantitative easing, or massive capital injections, is one way to combat unsustainable debt. If any institution can or will do this, it will not be the EFSF; it will be the ECB. As previously discussed, the EFSF faces the same solvency and credibility problems as sovereign nations. The ECB, on the other hand, operates supra-nationally and has the keys to the euro printing presses. Some of its prior emergency measures, such as the LTRO plan, already exhibit the characteristics of quantitative easing. Those who view such measures as half-hearted are calling for the ECB to launch a full-scale operation and to act as the “Lender of Last Resort”—i.e., directly backstopping government debt by purchasing bonds en masse. To accomplish this, the ECB would have to be willing to print euros
liberally. But so far, Germany has staunchly opposed this course.\textsuperscript{214} Germany likely fears not only hyperinflation, but also putting its own solvency on the line.\textsuperscript{215} Those who wish to avoid the subject flatly object that quantitative easing is beyond the ECB’s powers under the Maastricht Treaty.\textsuperscript{216}

A common Eurobond would restructure sovereign debt by spreading out the collective debt burden among Eurozone members. In theory, a Eurobond would mean each Eurozone nation would pay the same interest rate on its debt, and repayment would be comminized.\textsuperscript{217} Those who oppose the Eurobond argue that interest rate differentials are one of the last bulwarks of discipline against reckless sovereign borrowing.\textsuperscript{218} At any rate, once again, the more fiscally sound countries like Germany vehemently oppose this option, which has virtually no upside appeal for them. A Eurobond would essentially cross-collateralize sovereign debt, and the German people are understandably opposed to acting as a guarantor for the weaker, periphery nations. Germany would probably agree to this solution only after a tighter fiscal union within a union is created, and the weaker links within the Eurozone like Greece or Portugal have been squeezed out or become thoroughly controllable. Eurobonds recently found a new champion in the newly elected French President Hollande—a development that has rekindled this debate.\textsuperscript{219} It remains to be seen whether Germany stands its ground on mutualizing Europe’s debt, but the Eurobond could prove a defining issue.

If the Eurozone cannot or will not implement quantitative easing or shuffle the debt with Eurobonds, we could very well see systematic write-downs of sovereign, and even private, debt. Coordinated or controlled write-downs of existing debt would be an extreme method of restructuring because such measures are devastating to the confidence of creditors and investors alike. Additionally, if the cuts are broad enough, they have the potential to wipe out the banks, which were heavily exposed to that debt and then forced to swallow its loss.\textsuperscript{220} On the plus side, write-downs result in real debt relief and end the painful process of deleveraging.\textsuperscript{221} To see how these write-downs work in practice, one need only look to the ongoing negotiations between Greece and its private bondholders. Forced write-downs are like the government hitting a credit restart button—it is jarring and risky, but hopefully will clear the path for true growth.

To be effective, write-downs would have to target the most heavily leveraged sectors for each nation, and wherever possible, acknowledge the vast losses of creditors. For example, some nations like Greece and Italy would likely implement a write-down on sovereign debt. For others, a write-down on consumer loans or other private debts may be more effective. To prevent a collapse in the banking sector, governments may decide to recapi-

\textsuperscript{215} Id.
\textsuperscript{216} Id.
\textsuperscript{217} Id.
\textsuperscript{218} Id.
\textsuperscript{219} Id.
\textsuperscript{220} Id.
\textsuperscript{221} Id. at 6.
talize the banks after imposing strict controls to prevent bank runs. They may also decide to impose a one-time wealth-tax on financial assets to cushion the write-offs. Finally, for the restructuring to result in true growth, governments would have to obey strict debt ceilings going forward. But any restructuring that asks the public to pay for the mistakes of sovereigns and banks is a political minefield.

C. THE BANKING SECTOR URGENTLY NEEDS FISCAL REFORM

If there is one thing the crisis should teach us, it is that markets move more swiftly than governments. Whether the Eurozone nations choose closer integration or keep the status quo and instead focus solely on fiscal reforms, these political reforms will likely not keep pace with growing economic hazards. It is not enough to implement structural reforms reactively. Europe should proactively address the hazards in the banking sector.

1. Regulatory Reform

Better capital controls and regulations are necessary going forward to curtail risky behavior by banks. The Basel III accords endorsed by the G-20 nations are a step in the right direction. They would require banks to hold a higher percentage of capital as a buffer for economic downturns and introduce a new leverage ratio. But these reforms will not be fully phased in until 2019. It is also unclear how or if they will apply to non-financial institutions that created massive problems in 2008, such as hedge funds. To prevent banks from gaming the system, the leverage ratio ought to apply more rigorously and as broadly as possible across the financial sector (i.e., even to off-the-books sources of risk, like structured investment vehicles). The leverage ratio should have been the focal point of Basel III, instead of a “backstop” to support the new capital rules. And although banks lobbied against Basel III (evidence that it is, in fact, on the right track), even more capital buffers would be welcome given the banks’ gigantic leverage ratios.

Because Basel III will take years to implement, governments might consider more immediate reforms. One alternative to direct regulation would be a financial transactions tax, one that targets risky and socially unproductive transactions (i.e., credit default swaps). In September 2011, the European Commission submitted a proposal for such a tax. But to be effective, this tax would need to be universally applied—a daunting challenge for political leaders. It is also likely that financial institutions would find ways around the

222. Id. at 7.
223. Id. at 9.
227. Ewing, supra note 225.
229. Id.
tax, either by doing business in friendlier jurisdictions or by passing the cost of the tax onto consumers.230

2. Transparent Accounting

Banks should be held accountable for their investments—good or bad. It should be obvious to depositors and investors how much risk their banks have assumed. The only way to achieve this is to implement transparent accounting rules, and allow the IASB to function as a politically independent body. Mark-to-market accounting methods should be revived and strengthened. Banks should not be allowed to shuffle around their mal-investments to hide their insolvency. Accounting loopholes (like a bank recording questionable profits when its own bonds decline in value) should be closed. Solid accounting rules will go a long way towards strengthening fiscal reforms.

VI. Conclusion

The time to act is now. European leaders should focus their efforts on achieving true fiscal reform and debt reduction. Instead of shuffling mal-investment from banks to central banks, there must be meaningful liquidation to clear the path for true growth. It would be a mistake to think that endlessly subsidizing countries and banks that have made poor choices is a recipe for economic growth. A business model that allows a company to leverage itself excessively and continuously without accepting any of the corresponding risk would naturally provoke outrage on the part of those who are stuck with the bailout bill for that company when it bets the wrong way. Why should this logic not apply to banks and sovereigns?

230. Id.